Stonebridge Preferred Securities

Market Report

First Quarter, 2019

MARKET RECAP

Following a volatile fourth quarter in 2018 for financial markets, the preferred and hybrid securities market recovered sharply during the first quarter of 2019. The retail $25 par market led the outperformance, despite net outflows from passive preferred and hybrid exchange-traded funds (ETFs) during the quarter. The institutional $1000 par market and the European contingent convertible market (CoCos) were also very strong during the quarter, with long duration securities outperforming.

Global economic growth expectations diminished during the first quarter, as the trade dispute between the United States and China, BREXIT negotiations, and a prolonged government shutdown in the U.S. weighed on the economy. In response to the weakening economic data, central banks in the U.S. and around the globe became increasingly dovish, with the Federal Reserve (the Fed) signaling no additional rate hikes in 2019 and only one additional hike through 2021. The Fed also adjusted their balance sheet run-off strategy while the European Central Bank (ECB) planned for an extension of their Targeted Longer-Term Refinancing Operations (TLTROs) for the banking system and eliminated rate hike prospects through 2019. This accommodative policy, coupled with recession fears, caused 10-Year Treasury yields to fall during the period, with interest rates inverting on the 3-Month/10-Year part of the curve.

This dovish policy shift was positive for the entire preferred and hybrid securities market, particularly longer duration securities. Furthermore, tail risk from a no-deal BREXIT scenario decreased during the quarter as the UK parliament pushed for an extension of their withdrawal deadline. Although there was no consensus for an agreement, parliament was unified in their rejection of a no-deal exit from the European Union (EU). Meanwhile, the U.S. and China signaled that trade negotiations were progressing, although the timeline for a deal remains unclear.

Figure 1. Hybrid Preferred Securities Yield & Total Return Performance Relative to Other Indices

Index	Ticker	Average Rating	Effective Duration[1] 1Q2019	Current Yield 1Q2019	Total Return 1Q2019	Total Return FY2018
ICE BofAML Fixed Rate Preferred Securities	**P0P1**	**BBB2**	**4.56**	**5.62%**	**8.71%**	**-4.34%**
ICE BofAML Core Plus Fixed Rate Preferred Securities[2]	**P0P4**	**BBB3**	**4.82**	**5.95%**	**8.76%**	**-3.70%**
ICE BofAML US IG Institutional Capital Securities[2]	**CIPS**	**BBB2**	**4.72**	**5.56%**	**7.52%**	**-4.52%**
ICE BofAML US HY Institutional Capital Securities	**HIPS**	**BB1**	**4.24**	**5.94%**	**9.45%**	**-6.27%**
ICE BofAML USD IG Contingent Capital[2]	**COCU**	**BBB3**	**3.71**	**6.21%**	**6.47%**	**-3.57%**
ICE BofAML US Corporate	C0A0	A3	7.18	3.95%	5.01%	-2.25%
ICE BofAML US Cash Pay High Yield	J0A0	B1	3.70	6.39%	7.40%	-2.26%
ICE BofAML US Current 10-Yr U.S. Treasury	GA10	AAA	8.67	2.57%	3.10%	-0.03%
ICE BofAML US Mortgage Backed Securities	M0A0	AAA	4.38	3.54%	2.27%	1.00%
ICE BofAML US Municipal Securities	U0A0	AA3	6.86	4.22%	2.95%	1.04%
S&P 500	SPX	NA	NA	1.92%*	13.65%	-4.39%

Source: Stonebridge Advisors LLC, ICE Data Services; *Dividend yield. Past performance is no guarantee of future results.

[1] Effective duration – A measure of a fixed-income security's sensitivity to changes in interest rates reflecting the expected change in price given a 100 basis point rise in rates, including the impacts of embedded options.

[2] Please note that effective January 1, 2017, we are using the ICE BofAML Core Plus Fixed Rate Preferred Securities Index (P0P4), to represent the $25 par retail preferred securities market. We believe that this index is a more accurate representation of the retail preferred securities market than the ICE BofAML Fixed Rate Preferred Securities Index (P0P1) that we previously used given that P0P1 now has material exposure to the $1000 par institutional preferred securities market. We also now use the ICE BofAML U.S. IG Institutional Capital Securities Index (CIPS) to represent the $1000 par institutional preferred securities market. For Q1 2018, we changed the Contingent Convertible Index from CoCo to CoCu, the ICE BofAML USD Investment Grade Contingent Capital Index. This index is 100% USD CoCo securities, which we believe is a more representative sample of our investible universe than CoCo, which contains multiple currencies.

IN THIS ISSUE:

Highlights:

- Passive preferred and hybrid ETFs experienced almost $30 million in redemptions during the quarter, while active preferred and hybrid ETFs added over $110 million.
- Valuations within the preferred and hybrid securities market (P0P1) ended the period at ~102% of par after ending 2018 at the lowest level in five years (~95% of par).
- The CoCo market experienced its first example of extension risk, as Banco Santander did not call its Euro-denominated 6.25% coupon security on its first call date. The market initially reacted negatively, but the price recovered quickly, exhibiting the continued maturation of the CoCo market.
- The interest rate curve continued to flatten as the difference between the 2-year and 10-year Treasuries tightened to 14 basis points (bps) from 20 bps during the quarter, while the 3-month and 10-year part of the curve inverted.
- Current yield spreads of preferred and hybrid securities (P0P1) versus 10-year Treasuries (GA10) widened by 3 bps during the period, despite the rebound in performance.
- Fundamentals within the U.S. and global banking system remain strong. Bank capital ratios have almost doubled from pre-crisis levels, liquidity has been significantly enhanced, and asset quality is on a stable and still improving path.

Issuance

- **Strong issuance in Q1.** The market saw a substantial amount of issuance in both the retail and institutional market during the first quarter. Nearly all of U.S. issuance came in the $25 par market, and most of the institutional deals came from Europe in the form of CoCos. Approximately 50% of all issuance came during the last month of the quarter.
- **New names coming into the space.** New issuers launched deals in the preferred and hybrid securities space during the first quarter. For example, companies such as Air Lease Corp., which had not previously issued in the preferred and hybrid securities space, came with $25 par securities. These securities were well received and this trend helped alleviate some of the fears from the retail market's shrinkage over the past few years.
- **A quarter of growth for the retail market.** A concern for the retail market has been its shrinking supply trend over the past few years. The first quarter witnessed a net positive issuance of $5.03 billion. The increased retail issuance mainly came from U.S. companies, reflecting the attractive valuations in the market. The large net positive issuance was also led by some large deals, including one from JP Morgan at $1.85 billion and another from Duke Energy at $1 billion.
- **Net new supply will be limited.** During the first quarter of 2019, we witnessed an uptick in issuance in both the retail and institutional market following the poor market conditions in 4Q18, which made it difficult to launch new deals. Another driver of increased issuance was the strong investor demand, which allowed issuers to achieve attractive levels, particularly in the retail market. This strong demand was reflected by nearly all new deals pricing below their initial price target and being oversubscribed. We believe these market conditions resulted in a number of companies pre-financing future security redemptions. We expect that this should limit net new supply for the remainder of 2019.

Interest Rates & Central Bank Policies:

- **The Fed and ECB made a decidedly dovish policy shift in the first quarter,** with both central banks essentially committing to hold rates throughout the rest of the year. The Fed did so through the dot plot, while the ECB was more explicit. The central bank meetings led to a rally in the rates market, as well as talk of a rate cut at some point to unwind the December hike. In our view, these actions should dampen Treasury yield curve moves for the foreseeable future. We believe negative yields in Europe should also serve to anchor rates here in the U.S.
- **Curve inversion also raised recession fears,** although the inversion is more concentrated in the front end of the curve, thus highlighting the market's view that the Fed should not have hiked in December. However, the curve remains positively sloped beyond three years, which calls into question to what extent the market is actually expressing recession concerns.
- **We do see the potential for curve steepening in the latter half of the year** despite a dampened view of rate moves looking out over the next few months, as a U.S.-China trade deal and BREXIT resolution could improve economic growth prospects globally and shift central bank rate expectations higher.

Macroeconomic & Geopolitical Trends:

- **Trade war risks have tipped to the upside, but an agreement remained elusive in the first quarter.** As global growth slowed and both U.S. and Chinese financial markets experienced significant volatility, the rhetoric coming out of the Trump Administration became more optimistic about reaching a trade agreement. Talks remained unresolved going into the second quarter, but the market appears optimistic that a deal will be reached in the coming weeks. Should this occur, we would expect an uptick in economic growth expectations. However, a failure to reach a trade deal remains a major risk factor in the market.
- **The second quarter started off with positive data after mostly missing expectations throughout the first quarter.** Economic data was generally weak throughout the first quarter, and was mostly reflected in disappointing PMI readings, as well as lower employment data. However, the second quarter started with a positive surprise in the China PMI reading, suggesting to us that negative economic surprises may have bottomed.
- **The first quarter concluded without a BREXIT resolution.** BREXIT remained the top political risk in Europe during the first quarter of 2019. The March 29th deadline was extended into April, so the first quarter concluded without resolution. In our view, the market is most concerned with avoiding a no-deal BREXIT, and the majority of parliament strongly supports avoiding no-deal as well. We continue to place the highest probabilities on either an agreement or a lengthy extension of Article 50, which we believe has to occur by April 18th, when the EU parliament dissolves ahead of elections.

Credit:

- **Credit fundamentals remain strong.** We believe global bank fundamentals in particular will remain strong in 2019. Revenue and earnings trends are back to pre-financial crisis levels for most major U.S. and European banks, while average equity capital ratios have generally doubled during the same time period. Asset quality remains on a stable and still improving path across the majority of issuers of preferreds and hybrid securities, and the average credit rating of issuers is A- at the senior debt level.
- **The credit market expresses a more stable view of the financial sector.** As the Treasury market rallied and sparked a selloff in bank equities, we observed that the credit market took a more sanguine view of the impact of lower rates on bank credit profiles. Bank credit spread moves were muted in late March, supporting the view that the selloff in bank equities was more reflective of sector rotation (the "sell banks on lower rates" playbook) as opposed to a material change in bank fundamental outlooks.

Market Structure:

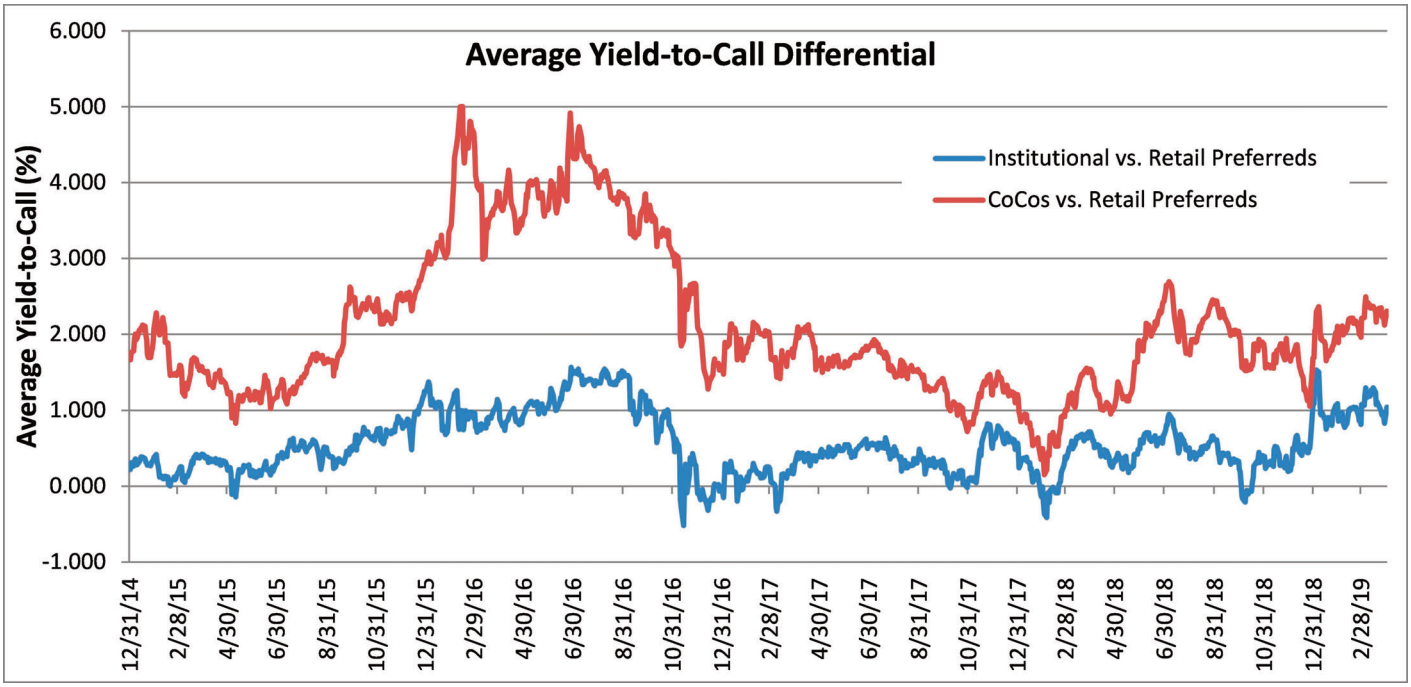
- **LIBOR[3] Update** — There were no notable regulatory developments on LIBOR during the first quarter, as regulators continue to solicit feedback from market participants on several key initiatives for a smooth transition. The LIBOR subject drew extra attention earlier in the year, as a few news and research outlets published commentary on the LIBOR language in prospectuses of certain preferred securities, most notably those of Citigroup. In our opinion, no new information was brought to light by these recent reports, but prices of certain preferreds were still impacted. Citigroup has indicated publicly on several occasions that utilizing the less favorable contractual dividend reset language would likely result in significant investor backlash and potentially drive up their overall cost of funds. Such comments were encouraging for preferred investors.

Preferred and Hybrid Valuation:

- **Preferred & hybrid securities screen well relative to other asset classes.** We believe relative valuations in the preferred and hybrid securities market should be supported going forward by high quality underlying credit, attractive duration profile and high current yields compared to other asset classes (see Figure 1 for comparison).
- **Yield to call better in $1000 par over $25 par securities.** As a result of the recent move higher in the market, we generally see more opportunities in institutional $1000 par securities than the retail $25 par exchange-traded securities due to better yield profiles, as well as more favorable security structures and characteristics. Figure 2 (on next page) is evidence of the incrememental yield pickup in institutional $1000 par bank preferreds and European CoCos over retail $25 par bank preferreds on a yield to call basis. That being said, we continue to see individual opportunities in $25 par exchange-traded securities, but believe there is generally more upside potential in the institutional $1000 par market.

[3]The London Interbank Offered Rate (LIBOR) is a benchmark interest rate that banks charge each other for short-term loans.

Figure 2. Average Yield-to-Call Differential (%) of Retail vs Institutional Securities



Source: Bloomberg, Stonebridge Advisors LLC. Retail and Institutional Preferred composites represent preferreds of U.S. G-SIB and large regional banks. The CoCo composite represents US$ CoCos of non-U.S. banks. Composites include issues with at least three years remaining to the first call date.
Past performance is not indicative of future results.

- **Investors are not being properly compensated to move into longer duration securities.** We prefer intermediate and short duration preferred and hybrid securities over longer duration securities as we do not believe investors are getting compensated to move further out on the yield curve. Longer duration securities tend to be less liquid and have less favorable security structures, while generally not offering additional yield over similar quality intermediate and shorter duration securities.

Investment Outlook

Given the current environment as outlined above, we believe the fundamentals for outperformance of preferred and hybrid securities remains intact. Solid credit fundamentals, high-yields compared to other fixed-income asset classes, and a low-rate environment are supportive of the preferred and hybrid securities market. As a result, we believe preferreds and hybrids have room for further appreciation along with attractive projected income. This could result in double digit returns for 2019.

The first quarter performance for the Taxable Preferred Composite and the Tax-Advantaged QDI Preferred Composite are available upon request by contacting Stonebridge Advisors LLC at 203-762-0004.